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# European Economic Forecast

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# 30. MONTENEGRO

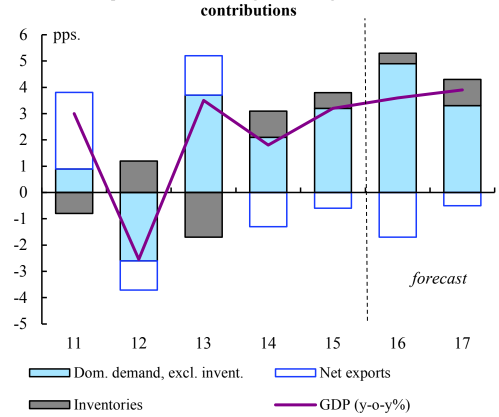
## Volatile growth amid public finance concerns

*Tourism and capital-intensive projects continue to be the main drivers of growth, albeit their contribution appears more volatile than previously expected. The growth potential is hampered by the sluggish recovery of bank lending. Budget deficits remain high due to a surge in public investment and social security transfers, raising concerns about fiscal sustainability. External imbalances have narrowed but the trend is set to reverse in view of a projected increase in investment-driven imports.*

### Growth performance was more volatile than expected

After recording a strong expansion in the first three quarters of 2015 the economy slowed down significantly in the last three months, due to a sharp contraction in government consumption and gross fixed capital formation as major public works were delayed. On the other hand, private consumption gained further strength in the last quarter, partially offset by a weaker contribution of net exports resulting from strong growth of imports.

*Graph II.30.1:* **Montenegro - GDP growth and contributions**




### Underlying assumptions remain unchanged but growth path is reviewed downwards

The medium-term growth continues to rely on large infrastructure and FDI projects already in the pipeline. However, given the weaker performance observed in the last quarter of 2015, the pace of implementation in gross fixed capital formation has been reviewed downwards compared to the winter forecast.

Real GDP growth is projected to remain relatively robust at slightly below 4% in 2016 and 2017. The recovery of private consumption is to be boosted by recent increases in pensions, public sector wages and social transfers. A contribution is expected from a modest revival of bank lending to households too. However, although higher economic growth is expected to improve banks' profitability and ease lending conditions, a weak asset quality in combination with low provisioning is likely to constrain overall credit growth over the forecast horizon.

### Investment-driven imports would increase the external deficit

The current account deficit remains significant albeit some gradual reduction has been recorded over the last years. In 2015, the strong services account surplus (above 20% of GDP) helped reducing the external deficit in spite of some further deterioration of the trade deficit. However, it appears difficult for services performance alone to further improve and offset - also in 2016 and 2017 - an investment-driven deterioration of the trade deficit, especially when considering the narrow export base of the country.

### An environment of moderate inflation

Inflation trends fell markedly in the first months of 2016 reflecting the combination of low commodity prices and the still weak private consumption. As a result the inflation forecast for 2016 and 2017 has been slightly revised downward.

### The impact of the economic recovery on the labour market is low

Despite some further improvement, labour market dynamics remains hindered by rigidities, skills mismatch and demand side constraints. The overall situation is expected to offer a similar trend in the coming years.

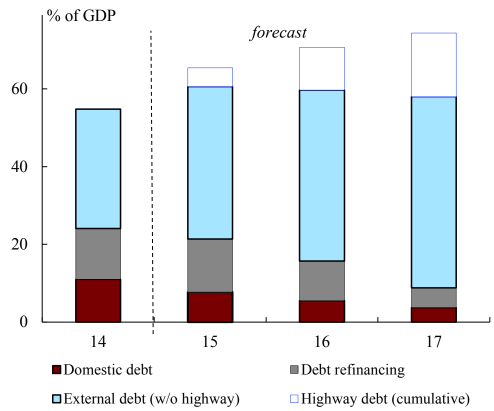
After several years of weak or negative growth, wages are set to increase in 2016 following the adoption of the Law on public sector employees. As a result, public sector wages could increase by average 5% in 2016. However, the wage increase in the private sector could be more moderate given the still large unemployment rate. In 2017, wages would increase less than in 2016 due to the absence of elections and of fiscal space.

## A substantial deterioration in public finances

Highway related expenditures and borrowing started taking their toll in 2015, swelling general government deficit and debt. Thus, at the end of 2015, the general government deficit surged above 8% of GDP, half of it accounting for expenditure on one highway section, and additional 2% of GDP on unplanned repayment of arrears of local governments. Political uncertainty emerges in the electoral year 2016 as a risk for the sustainability of public finances and the implementation of the structural reforms agenda. So far, the situation has already further deteriorated in early 2016 due to a series of increases in pensions, social benefits and public sector wages partially related to the electoral cycle.

Under a no policy change assumption, the forecast projects a narrowing of fiscal deficits in 2016 and 2017 due to the growth effect and the contention of expenditure on real terms, while public debt would further increase driven by the loan-financed highway, despite further contraction of domestic public debt.

*Graph II.30.2:* **Public debt stock**




Considering the very high gross financing needs, maintaining access to capital markets appears as the key challenge. Another important risk is the uncertainty related to the political situation and the possible agreement between government and opposition to share government responsibilities before elections, which could delay the reforms necessary to stabilize public finances.

*Table II.30.1:*

**Main features of country forecast - MONTENEGRO**

| | | 2014 | | | Annual percentage change | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | mio EUR | Curr. prices | % GDP | 96-11 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
| GDP | | 3457.9 | 100.0 | - | -2.7 | 3.5 | 1.8 | **3.2** | **3.6** | **3.9** |
| Private Consumption | | 2774.8 | 80.2 | - | -3.9 | 1.6 | 2.9 | **0.7** | **1.9** | **2.1** |
| Public Consumption | | 669.9 | 19.4 | - | 3.0 | 1.3 | 1.4 | **2.9** | **4.9** | **2.9** |
| Gross fixed capital formation | | 657.1 | 19.0 | - | -2.4 | 10.7 | -2.5 | **10.5** | **12.0** | **5.0** |
| of which: equipment | | - | - | - | - | - | - | **-** | **-** | **-** |
| Exports (goods and services) | | 1388.1 | 40.1 | - | -0.3 | -1.3 | -0.7 | **10.2** | **0.9** | **3.2** |
| Imports (goods and services) | | 2074.2 | 60.0 | - | 0.6 | -3.1 | 1.6 | **7.9** | **3.4** | **2.9** |
| GNI (GDP deflator) | | - | - | - | - | - | - | **-** | **-** | **-** |
| Contribution to GDP growth: | Domestic demand | | | - | -3.0 | 3.7 | 2.1 | **3.2** | **4.9** | **3.3** |
| | Inventories | | | - | 0.9 | -1.7 | 1.0 | **0.6** | **0.4** | **1.0** |
| | Net exports | | | - | -0.6 | 1.5 | -1.3 | **-0.6** | **-1.7** | **-0.5** |
| Employment | | | | - | 2.2 | 1.1 | 3.1 | **2.0** | **1.8** | **2.1** |
| Unemployment rate (a) | | | | - | 19.8 | 19.5 | 18.6 | **17.8** | **17.1** | **16.6** |
| Compensation of employees / head | | | | - | 0.9 | -2.0 | 2.1 | **0.5** | **3.0** | **1.7** |
| Unit labour costs whole economy | | | | - | - | - | - | **-** | **-** | **-** |
| Real unit labour cost | | | | - | 5.8 | -6.2 | 2.4 | **-1.4** | **-0.4** | **-2.0** |
| Saving rate of households (b) | | | | - | - | - | - | **-** | **-** | **-** |
| GDP deflator | | | | - | - | - | - | **-** | **-** | **-** |
| Consumer-price index | | | | - | 4.3 | 1.8 | -0.5 | **1.4** | **1.5** | **2.0** |
| Terms of trade of goods | | | | - | - | - | - | **-** | **-** | **-** |
| Trade balance (goods) (c) | | | | - | -43.7 | -39.5 | -39.8 | **-40.7** | **-40.7** | **-40.5** |
| Current-account balance (c) | | | | - | -18.5 | -14.5 | -15.2 | **-13.4** | **-13.8** | **-14.7** |
| Net lending (+) or borrowing (-) vis-a-vis ROW (c) | | | | - | - | - | - | **-** | **-** | **-** |
| General government balance (c) | | | | - | -6.0 | -5.2 | -2.8 | **-8.5** | **-6.2** | **-6.1** |
| Cyclically-adjusted budget balance (d) | | | | - | - | - | - | **-** | **-** | **-** |
| Structural budget balance (d) | | | | - | - | - | - | **-** | **-** | **-** |
| General government gross debt (c) | | | | - | 53.4 | 57.5 | 54.8 | **62.8** | **70.7** | **74.4** |

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.